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By

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BANKING, FINANCE

AND

CARIBBEAN DEVELOPMENT

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ABSTRACT

The banking and finance sector has obviously made a very significant contribution to development in the Caribbean, especially within the last two decades. However, the contribution is far from optimal, owing to the interplay of certain external and internal forces. First, there is a considerable degree of macro-systemic repression, in the sense that the financial determinants of growth have become subordinate to the contractionary policy dictates of global integration. Second, there are a number of major operational distortions and market failures, making for mal-distribution in the loans portfolio of the financial institutions. Third, there seems to be an emerging tendency for random financial implosion, which can derail the economy from a steady growth path, partly because an increasingly liberalised and competitive environment is not being matched by effective prudential regulation and careful monitoring and supervision.

BANKING, FINANCE AND CARIBBEAN DEVELOPMENT

By

MAURICE ODLE

(I) Introduction

In dealing with the vexatious subject of the relationship between the finance sector and the real sector, this time in the context of Caribbean development, I shall draw heavily on work that has been done in recent times on experiences in the last two decades. But first a brief review is in order of the literature relating to both theoretical and empirical work on the relationship between financial intermediation and development. The Paper then describes the structural development of the financial sector in the Caribbean and its possible real sector impact. The issue of global liberalisation resulting in increasing competitiveness is then discussed in order to deduce possible real sector effects. But for the economy to benefit from the liberalisation process, financial stability has to be maintained and so the Paper next deals with this subject. A conclusion then follows.

(II) Theory of Financial Intermediation and Development

Since the onset of the Depression of the 1930s, economists have been concerned with the nature of the relationship between the financial sector and the real sector. As a result, a considerable body of literature arose concerning the relationship between quantity of financial capital and economic development and the direction of causality. Certain Caribbean scholars, in turn, have attempted to determine the nature of the relationship in their own economies and to deduce whether there is a supply leading relationship or a demand following relationship. In recent years, considerable work has also been done on the qualitative nature of the financial institutional arrangements and economic growth. This latter qualitative aspect is likely to engage the attention of researchers for some time to come, especially given the difficulties of the Japanese and South East Asian banks within the last year or so and the related dramatic declines in economic activity.

Literature on the relationship between quantitative finance and economic development has been concisely surveyed by Laurence Clarke (L. Clarke and D. Danns 1997). Theorizing started in 1933 with Irving Fisher relating the decline in economic activity with finance sector failures and, in 1955, John Gurley and Edward Shaw improved the theorizing by including near money in the financial aggregates. A very major contribution to the literature was provided by Raymond Goldsmith in 1969 who formulated a relationship between the financial system or superstructure and the real economy or infrastructure, a measure he termed the Financial Interrelations Ratio. Based on the experiences of three dozen developed and developing countries over the period 1860-1963, Goldsmith was able to show that there was a typical direct correlation between the evolving nature of financial structures and economic development over time, even though the direction of causation was still in doubt.

Another major contribution was that made by Ronald McKinnon (1973) and Edward Shaw (1973) who, independent of each other, arrived at the same conclusion that liberalisation of the financial sector will promote deepening and enhance both the quantity and quality of productive investment.

The next really significant advance in the literature occurred with the introduction of the notion that, owing to asymmetric information, a liberalised financial sector may not lead to a socially optimum level of investment. Conversely, the greater the degree of symmetry of information, the less likely is there to be a problem of adverse selection and moral hazard by portfolio managers of financial institutions (Maxwell Fry, 1988).

A useful but rather terse literature survey of the role of information gathering by financial intermediaries and its fostering of economic growth is that by Raju Jan Sing (1997). Two endogenous channels are involved in showing that growth rates can be related to institutional arrangements in financial markets:

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"First by providing an opportunity to hold a diversified portfolio, a financial intermediary enables risk-averse individuals to invest in riskier but more productive assets or technologies (see, for instance, Bencivenga and Smith, 1991; Levine, 1991; Saint-Paul 1992). Second, by gathering information, a financial intermediary is able to improve the quality of projects being financed (Greenwood and Jovanovic, 1990; King and Levine, 1993b)...It has been claimed that banks are able to gather this additional information at a lower cost than other financial intermediaries, through the process of taking deposits and through close contacts with customers (Fama, 1985). Frequent contacts with potential borrowers provide banks with a better knowledge of their clients and help them to evaluate less tangible but nevertheless important 'assets', such as managerial skills or dynamism".

In surveying the literature on the Caribbean experience, *per se*, Clarke mentioned four works. The first (Clarke 1986) examined the phenomenon of 'financial asphyxiation', i.e., the stifling of non-banks by banks and found that while there was not a significant amount of stifling (in Jamaica and Trinidad and Tobago) when it did occur there was real potential for an adverse impact on real sector development. A more direct examination of the finance-real sector nexus was undertaken by Compton Bourne (1988) who found that financial deepening in Trinidad and Tobago had a strong positive influence on investment and economic growth. Third, Anthony Wood (1993) found the relationship between financial development and economic growth in Barbados to be demand following during 1946-1968 and supply leading during 1969 to 1990. Fourth, Anthony Birchwood (1997) found a supply leading relationship between the financial sector (using commercial bank credit to GDP as the financial deepening variable) and economic growth in Trinidad and Tobago.

While statistical correlation tends to point to a supplier-leading relationship between finance and development in the Caribbean, it begs the question as to whether the intermediation process could be so improved as to result in an improvement in both quantity (financial widening) and quality (financial deepening). In this regard, three issues spring to mind. The first relates to whether savings mobilisation is as catchment friendly and cost-effective as it could be. The second concerns the global process of financial liberalisation and whether increased competition will lead to quantitative widening, qualitative deepening and increased allocative efficiency. The third is whether increased cross-border flows (via the international inter-bank market) stimulated by globalisation and liberalisation could be integrated into the national financial system without severe real sector downturns if sudden outflows take place, as has occurred in South East Asia. The fourth is whether monetary and exchange rate policies in the Caribbean can be so crafted as to permit financial institutions to offer a competitive interest rate to depositors that is high enough to prevent capital flight without at the same time being punitive to real sector borrowers. The analysis, below, alludes to these issues, *inter alia*.

(III) *Finance Sector Structural Performance and Economic Development in the Caribbean*

Over the last two decades, financial intermediaries in the Caribbean recorded appreciable growth, in both absolute terms and in relation to GNP. Two natural questions to ask is whether the growth in the financial sector could have been greater, or the distribution of asset shares between institutions more optimum, and whether, even with the given financial levels, the impact on the real sector could not have been greater.

Table I shows that, during 1975-95, on average the banking system grew annually by 7 per cent, thrift institutions by 19 per cent, insurance companies by 8 per cent and miscellaneous financial institutions by 7 per cent. The average annual growth rate for all these institutions combined was 8 per cent. The growth performance in the first decade was much better than in the second decade for all four groups of financial institutions. Table 2 tends to indicate that, in addition to the widening referred to above, a considerable amount of financial deepening was also occurring (Bourne, et al, 1998). Both the monetization ratio and the financial intermediation ratio rose during the 1975-95 period. However, the finance ratio (measuring financial assets/GNP) fell and this probably explained by financial suppression associated with structural adjustment and the effect of the infrastructure boom of the late 1970s and early 1980s finally manifesting itself in GNP terms.

In terms of the level of financial development, the Caribbean countries seem to compare well with Latin America. However, as Table 3 indicates, and as can be expected, they lag behind the Asian NICs and the OECD countries in a number of selected indices. Table 4 shows the percentage share of total financial intermediaries' assets between commercial banks, near banks and other institutions in a number of Caribbean countries. In most cases, the share of commercial banks is over two-thirds (_) of total assets and "their dominance is even greater than their explicit share suggests, as many near banks are in fact subsidiaries or affiliates of commercial banks, established to escape the high regulatory costs imposed on the latter" (CGCED 1998). If the near bank share were added to the commercial bank share, the total bank share would tend to exceed three-quarters (¾) in most cases, although it may still be lower than many other developing countries. For example, in Mexico, Brazil and Argentina, commercial banks are said to account for 80-95 per cent of total intermediary assets.

Table 1: CARICOM: Estimates of Consolidated Financial Sector Position (1975-1995)

(US$ Millions)

	TOTAL ASSETS			AVERAGE GROWTH RATE P.A.		
	1975	1985	1995	1975-85	1985-95	1975-95
1. The Banking System[a]	4596.6	15458.9	18214.6	13%	2%	7%
2. Thrift Institutions[b]	52.2	476.5	1569.1	25%	13%	19%
3. Insurance Institutions	268.7	127.3	1354.2	17%	1%	8%
4. Miscellaneous Institutions[c]	553.3	1972.9	2316.1	14%	2%	7%
ALLFINANCIAL INSTITUTIONS (ESTIMATES)	5470.8	19179.6	23454.1	13%	2%	8%

[a]Consists of central and commercial banks

[b]Consist of post office savings banks, pensions schemes, credit unions and building societies. Exclude data for [c]The Bahamas 1995; Belize 1975; Suriname and the OECS for all years.

Consist of trust and mortgage companies, finance companies, merchant banks and development banks and corporations. Exclude data for Suriname and the OECS for all years.

Source: The Financial Evolution of the Caribbean Community (1970-1996) 1997) eds. L. Clarke & D. Danns,

Table 2: Indicators of Deepening and Broadening of CARICOM Financial Sector (1975-1995) (Average Ratios)

	1975	1985	1995
Monetization Ratio[1]	0.44	0.58	0.69
Finance Ratio[2]	7.0	6.64	6.23
Financial Intermediation Ratio[3]	0.42	0.47	0.49

Notes: [1] Broad Money/GNP
[2]Total Financial Assets/GNP
[3]Total Financial Assets of Financial Institutions/Aggregate Financial Assets

Source: The financial Evolution of the Caribbean Community (1970-1996) (1997) (op cit)

According to the theory of financial intermediation, and the experience of present day developed countries, assets share of commercial banks falls during the course of economic development. The commercial banks share of Caribbean countries is therefore still higher than that of the OECD countries. The combined share of commercial banks and near banks still does not seem to be significantly falling in the Caribbean, suggesting that the financial system has not yet reached the stage of maturity. Commercial banks have continued to grow rapidly as well as merchant banks and finance companies, although the latter two institutions hardly exist outside of Jamaica and Trinidad and Tobago. But the fastest growth is said to be among the thrift institutions of savings banks, post office savings banks, pension schemes, credit unions and building societies. Rapid growth has also been experienced in the offshore banking system, although this highly specialised institution exists in only a few CARICOM countries. The same situation obtains with respect to stock exchanges.

An alternative proxy variable for assessing both the density and penetration of the financial system is the number of firms, and related increases, in each institutional category. In this regard, Table 5 is of some usefulness. However, it does not indicate the size of the various institutions. Moreover, in recent years, there have been a number of mergers and acquisitions within the Caribbean financial system (Glen Khan, 1996).

The most telling proxy indicator of the mobilisation capability of the Caribbean financial system is probably the size of gross domestic savings as a percentage of GDP. This figure does not exceed 20 per cent in a number of Caribbean countries, whereas in South East Asia it is well over 25 per cent.

Table 3: Indicators of Financial Development (1995)

	(1) Domestic Bank Credit as % of GDP	(2) Quasi-liquid liabilities as % of GDP	(3) Credit to private sector as % of GDP	(4) Stock market capitalization as % of GDP	(5) Stock market turnover ratio
The Bahamas	44	37	45	-	-
Barbados	46	42	40	38	<1
Belize	48	35	40	-	-
Dominican Republic	19	16	24	small	na
Guyana	57	49	30	-	-
Haiti	11	18	11	-	-
Jamaica	36	35	17	32	22
OECS	83	75	70	-	-
Suriname	50	46	44	2	na
Trinidad and Tobago	36	38	44	27	15
Average Caribbean	43	39	37	na	na
Bolivia	43	27	44	2	2
Brazil	34	24	32	21	47
Chile	49	29	51	109	16
Mexico	29	22	32	37	31
Average LAC	26	23	28	23	19
Average Asian NICs	104	81	111	136	47
Average OECD	114	56	88	55	66

Source: CGCED, Increasing Competitiveness and Financial Resource Management for Economic Growth, 1998 and based on Loayza and Palacios (1997) and miscellaneous

TABLE 4: FINANCIAL INTERMEDIARIES: PERCENTAGE SHARE OF TOTAL ASSETS

	Bahamas	Barbados	Belize	Dominican Repub.	Guyana	Haiti	Jamaica	OECS	Suriname	Trinidad & Tobago
	1995	1996	1996	1992	1995	na	1994	1995	na	1993
Com. Banks	69	55	69	68[2]	64		65[2]	72		51
NearBanks[1]		18	1	22	11		28	-		14
Dev. Banks	11	1	7	9	8		5	3		4
Credit Union		2	8	na	0.1		2	5		5
Ins. Cos		11	2	na	8		na	4		14
Soc. Sector	20	13	14	na	9[3]		na	16		10
Total	100	100	100	100[2]	100		100[2]	100		100[4]

Sources: CGCED, Increasing Competitiveness and Financial Resource Management of Economic Growth, 1998 and based on CCMS, Miscellaneous.

[1]Thrifts, trust and mortgage finance companies, merchant banks, etc.

[2]Percentage share of total depository institution assets only.

[3]Social Security 4%; private pensions 5%

[4]Includes Home Mortgage Bank (secondary mortgage institution) 1%; Unit Trust 2%

Table 5: Structural Evolution of Financial Sector of CARICOM Countries (1975-1997)[1]

Number of Firms

COUNTRY	Commercial Banks			Offshore Banks			Finance Companies			Merchant Banks			Trust Companies			Mortgage Finance Companies		
	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997
BAHAMAS	10*	10*	10*	194**	273**	309**	-	na	na	na	na	na	71	91	99[I]	-		1[e]
BARBADOS (97)	6	7	7	-	3	30	1	3	4	-	-	-	3	4	4	1	1	1
BELIZE ('97)	na	na	4	-	-	-	na	na	2	6	-	-	na	na	80	na	na	2
GUYANA ('97)	6	6	7	-	-	-	-	-	1	-	-	-	2	2	2	1	1	1
JAMAICA	na	na	11	-	-	na	a	na	4		8	25	na	na	1	na	na	na
OECS ('97)	na	na	25	-	na	43	na	na	na	-	-	-	Na	Na	Na	-	0	1
SURINAME	6	6	6	-	-	-	na	na	6	-	-	-	-	-	-	na	na	na
Trinidad & Tobago ('96)	9	8	6	-	-	-	7	16	10[I]	-	4	6	5	8	6[e]	-	na	na

COUNTRY	Development Banks			Credit Union			Stock Exchange			Insurance Companies			Thrift Organisations			Unit Trust Companies		
	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997
BAHAMAS	-	1	1[c]	na	na	10	-		1	na	na	128	1	1	1	-	-	-
BARBADOS (97)	1	1	1	na	37	47	-	-	1	na	na	27	1	-	-	-	-	-
BELIZE ('97)	1	2	2[h]	na	na	21	-	-	-	na	na	20	1	1	1	-	-	-
GUYANA ('97)	1	1	1	na	na	na	-	-	-	16	na	11	1	1	1	-	-	-
JAMAICA	na	na	4	na	na	37	1	1	1	na	na	11[g]	na	na	15	na	na	4
OECS ('97)	na	na	7	55	73	74	-	-	-	na	na	185	na	na	na	na	na	na
SURINAME	na	na	1	na	na	27	na	na	1	na	12	na	12	na	na	na	na	na
TRINIDAD & TOBAGO ('96)	3	3	2	na	145	161	-	1	1	57	59	43	4	4	4	-	1	1

a - 425 licences
b - The Bahamas Mortgage Corporation
c - The Bahamas Development Bank
d - consists of 3 Savings & Loans (domestic) and 11 Banks and Trusts
e - Trust and Mortgage Finance Company
f - includes merchant banks
g - Life insurance

h - The National Development Foundation of Belize
The Development Finance Corporation
I - Offshore Institutions
na - Data not available
\- None existing

* 1995, 1985 and 1975 totals include both commercial banks (7) and mortgage banking institutions (3)
** 1995 totals include entities holding either a banking licence (150) or both a bank and Trust licence (159)
1985 totals include entities holding either a banking licence (173) or both a bank and Trust licence (100)
1975 totals include entities holding either a banking licence (144) or both a bank and Trust licence (50)

Source: C. Bourne et al, Competitiveness of Caribbean Financial Services and WTO Negotiating Strategies, 1998

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Table 5 (Cont'd): Structural Evolution of Financial Sector of CARICOM Countries (1975-1997) 1/

Number of Firms

COUNTRY	Export Credit Insurance			Reinsurance Company			Deposit Insurance			Home Mortgage Bank			Non Financial Cooperative			Insurance Related Funds			National Development Banks		
	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997
BAHAMAS	-	-	-	-	-	-	-	-	-	-	-	-	na	na	13	-	-	-	-	-	-
BARBADOS ('97)	-	-	-	-	-	-	-	-	-	-	-	-	na	na	na	-	-	-	1	1	1
BELIZE ('97)	-	-	-	-	-	-	-	-	-	-	-	-	na	na	na	-	-	-	1	1	1
GUYANA ('97)	-	-	-	-	-	-	-	-	-	-	-	-	na	na	na	-	-	-	-	-	-
JAMAICA	na	na	na	na	na	na	-	-	1	-	-	-	na	na	na	na	na	11	na	na	6
OECS ('97)	-	-	-	-	-	-	-	-	-	-	-	1	na	na	na	-	-	-	na	na	na
SURINAME	-	-	-	-	-	-	-	-	-	-	-	-	na	na	na	-	-	-	na	na	na
TRINIDAD & TOBAGO ('96)	-	-	1		1	-	-	-	1	0	-	1	na	na	na	na	na	na	1	1	1

COUNTRY	Licensed Foreign Exchange Dealers (Cambios)			National Insurance Schemes			Pension Schemes			Provision Funds			Stock Brokerage Firms			Investment Banks		
	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997	1975	1985	1997
BAHAMAS	-	-	-	1	1	1	na	na	na	-	-	-	-	-	-	-	-	-
BARBADOS ('97)	-	-	-	1	1	1	na	na	na	-	-	-	-	-	na	na	na	na
BELIZE ('97)	na	7	8	1	1	1	na	na	4	0	0	0	0	0	0	0	0	0
GUYANA ('97)	-	-	29	1	1	1	na	na	22	-	-	-	-	-	1	-	-	-
JAMAICA	na	na	na	1	1	1	na	na	na	-	-	-	na	na	10	na	na	7
OECS ('97)	-	-	-	na	na	8	na	na	na	-	-	-	na	na	na	-	-	-
SURINAME	na	na	na	na	na	na	na	na	29	na	na	5	na	na	na	-	-	-
TRINIDAD & TOBAGO ('96)	-	-	-	1	1	1	na	na	na	-	-	-	na	na	6	na	na	5 *

na - data not available
\- None existing
* Same as merchant banks

1/ Or earliest year before 1997.

Source: Individual CARICOM Central Banks and several regional publications, including "The Financial Evolution of the Caribbean Community (1970-1996)" edited by L. Clarke and D. Danns, CCMS (1997).

In an important sense, what is important from a developmental point of view is not only the volume of credit but, also, the distribution of credit. It is assumed that, if the private sector is indeed the engine of growth, then government should not be crowding out private borrowers. If, also, income growth is a function of investment (and related technological progress) then credit directed towards business investment should be maximised and consumption minimised, especially since the latter has a very large import component. Further, priorities would need to be established among competing claims to business investment funds. In this regard, the capacity to earn foreign exchange is paramount: "In Caribbean economies, it is not simply increased investments, but increased investments in the tradeable sector, that guarantee economic growth. The binding foreign exchange constraint is what dictates this pattern of investments" (Augustine Nelson, 1995, P 132).

With respect to commercial banks in the Caribbean, thee are a number of portfolio distribution factors which probably detract from the attainment of a maximum rate of real sector growth. First, the liquidity ratios are typically very high, partly because of the risk averting liquidity preferences of the banks, themselves, but, perhaps more importantly, partly because of the reserve requirements stipulations of monetary authorities and the latter's concerns about exchange rate stability. The high liquidity, in turn, tends to lead to higher deposit rate/lending rate spreads as commercial banks try to recoup on the per unit interest charged to borrowers. There are not many projects that can earn a rate of return sufficiently high to compensate for the very high cost of borrowing (Table 6). Those who do borrow would want to pass on to suppliers and consumers the high cost of capital and this would fuel any price rise, make imports relatively more attractive, with possible consequences for the exchange rate or the level of reserves. Second, the commercial banks' portfolio continues to be consumption oriented. For example, in The Bahamas, "in 1996, personal loans accounted for 65.2% of total private credit as opposed to just under 10% for tourism and the agriculture, fisheries and manufacturing sectors" (Wendy Craigg, et al, P. 98, 1996). In some Caribbean countries, the relaxation of credit control and increased reliance on the market have aggravated the problem of non-priority lending. For example, in Barbados "The removal of credit restrictions on the distribution and personal sectors has provided a boost to commercial bank lending

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TABLE 6: AVERAGE INTEREST RATES (1996) IN THE CARIBBEAN

	Bahamas	Barbados	Belize	Dominican Republic	Guyana	Haiti	Jamaica	OECS	Suriname	Trinidad & Tobago
Inflation	1.4	2.4	6.4	13.0	4.5	17.0	21.5	2.0	-0.7	3.4
Prime Loan Rate	6.8	10.0	16.3	15.0	17.8	24.0	44.0	10.3-12.3	27.0	15.8
Deposit Rate	5.1	5.2	9.1	8.0	10.5	13.0	25.2	4.0-7.0	12.0	7.7
Lending Spread	1.6	4.8	7.2	7.0	7.3	11.0	18.8	6.3	15 0	8.1

Source: CGCED, Increasing Competitiveness and Financial Resource Management for Economic Growth, 1998 and based on IMF, International Financial Statistics; and miscellaneous.

in these areas" (Cleviston Haynes, 1996). Third, in relation to the bias against non-commodity export-oriented activity, "there has to be a set of policy distortions of large proportions which provide incentives of higher return and lower risk to the non-tradeables, and especially to buildings, than to export of goods or services" (Neville Nicholls, 1998, P. 11). This is the explanation proffered for the size of the Caribbean estimate made by Delisle Worrell (1993) that over 50 per cent of investment in each country during the mid-1970s to 1980s went towards building construction with much of the rest in non-tradeable activities. However, according to Nelson, perhaps the fault lies neither with conservative banker preferences nor with a paucity of finance since "official efforts to provide financing for new ventures...included special discounts, preferential interest rate margins and concession on reserves requirements by Central Banks to encourage lending by commercial banks. The creation of specialised institutions for long-term financing, the establishment of stock exchanges and the provision of export credit and guarantees also featured"(P. 140). Rather it is a lack of entrepreneurship and, reinforcing the view of Delisle Worrell, a problem of a shortage of viable projects, that could convincingly secure financing.

It is debatable whether the performance of the near banks has been any better than the performance of the commercial banks. When finance houses and merchant banks are offshoots of commercial banks, and come into existence to circumvent monetary policy directed at these same commercial banks, it is not expected that their portfolio philosophy would be any different from that of the latter. The finance companies in Jamaica, Trinidad and Tobago and Suriname have contributed to the high propensity to consume. The merchant banks, for their part, have not restricted themselves to the medium to long term market to the extent that the authorities would have expected and desired. This was particularly the case in Jamaica. There remains a discrepancy between private benefits (profits) and social benefits.

At a very specialist end of the banking market, offshore institutions have been making their contribution to economic development, even though skepticism remains as to the true extend to same. For example, in the case of The Bahamas, it is said that the "gross contribution of the sector for 1996 is expected to exceed $260 million compared to $237 million in 1995. Since 1991, contributions from this sector have increased by an average 6.6% or more than $12 million per year" (Bahamas Central Bank, 1996).

In the long end of the financial market, insurance companies have been performing an important role in providing the mortgages for enhancing the physical infrastructure of the various Caribbean countries. However, it is doubtful whether the impressive number of national, regional and extra-regional firms in the industry is matched by an equally great contribution to economic development. Reinsurance needs still constitute a significant outflow of funds and the long promised regional re-insurance pool has still not come into being, even though in the interim, Trinidad and Tobago has set up its own re-insurance entity. Although local asset ratios are still in place in certain countries, these are sometimes not attained and seldom ever exceeded. Moreover, a large proportion of the commercial mortgages may be associated with low rate of return business activities. Also, there is limited linkage between business and household mortgages on the one hand and other industries in the economy on the other, since a not insignificant portion of the engineering materials, equipment and furnishings would tend to be imported. In Guyana and Jamaica, particularly, there is the added problem of persistently high interest rates on mortgages.

As an institution, stock exchanges in the Caribbean, except for The Bahamas, Barbados, Jamaica, Suriname and Trinidad and Tobago, have not proliferated. Nor has any grown sufficiently fast to compensate for the consumption bias in the other aspects of the financial system. For the two largest exchanges, in Jamaica and Trinidad and Tobago, while 74 listed stocks in 1985 accounted for total capitalisation of just of just over US$700 billion, this had grown to only 105 stocks by 1996, with capitalisation under US$4 billion. Stocks are relatively inactive. Regional cross-border trade is also rising only very slowly and the regional securities market remains very thin. Here again, the developmental problem does not lie with the traditional financial intermediaries end of the market, or with the volume of funds available to purchase equity or business securities given the strength of the insurance and pension funds sector, inter alia; rather the problem seems to lie with conservative and non-dynamic entrepreneurship business acumen and the tenacious nature of the family ownership ethic as against going public.

(IV) Competitiveness of the Caribbean Finance Sector and Developmental Implications

Financial services are a very sensitive sector and, despite the significant liberalisation worldwide within the last decade or so, it remained fairly protected up to the beginning of multilateral negotiations in the WTO in 1994 for further opening up. There are a number of developmental arguments that have been used by the WTO and others (WTO 1997; and WTO Focus, 1997) to justify a concerted commitment on the part of both developed and developing countries to further liberalisation and opening up. First liberalisation and greater competition from foreign firm entry can lead to general specialisation and related efficiency payoffs in market niches, segments and products, according to respective comparative advantages. Second, economies of scope are likely to result in a wider variety of services than would otherwise be the case. Third, economies of scale in technology acquisition and an associated faster rate of economic development can be had from a wider spread of knowledge on best practices. Fourth, reductions in systemic risk and related volatility and vulnerability to shocks may result from an increased incidence of transnational parent firm - subsidiary relationships in host economies. Fifth, improvements in risk management (particularly of large projects) may be derived from the ability of transnational banks to move funds around (from capital surplus to capital deficit countries) to take advantage of more attractive opportunities. Similarly, loan recipients can take advantage of lower interest rates, reduced currency risk and better insurance coverage. Sixth, consumer welfare is enhanced by the provision of better advice, better financial packages and more timely and custom made service.

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At issue is whether there is much room for further liberalisation in the Caribbean; whether if the region does proceed with such liberalisation there will be a significant increase in either foreign direct investment ("Commercial presence") or electronic commerce ("cross border supply" and "Consumption abroad"); and if significant competition does materialise, whether the expected beneficial impact on the real sector would be at all significant.

There are currently very few limitations in CARICOM countries with respect to the traditional forms of market access. In Trinidad and Tobago there is still a restriction on a foreign financial enterprise acquiring more than 30 per cent of an existing indigenous financial institution. However, in Jamaica, partly as a result of the global liberalisation process, the 51% equity restriction on foreign life and non-life insurance companies was lifted in 1997. In all the other CARICOM countries, 100% foreign ownership is allowed. But, as mentioned above, Jamaica so far remains in the unique position of imposing restraint on market access via cross-border and consumption abroad modes of supply.

Of course, there are the usual prudential forms of control in the CARICOM sub-region over the market access process and related licensing requirements. There are certain minimum capital requirements for foreign banking and insurance enterprises which, invariably, are more onerous than those pertaining to national firms. In addition, the Minister of Finance and/or the Governor of the Central Bank also exercise discretionary power in approving market entry based on the reputation and experience of the financial enterprise and the personal integrity of the owners/directors.

There exists one or two exceptions to national treatment. For example, in Guyana foreign commercial banks cannot make loans to subsidiaries of transnational corporations without governmental approval. This perhaps also obtains in Trinidad and the OECS countries. The reason for this is the fear that without such controls, a disproportionate share of credit would accrue to foreign companies at the expense of indigenous enterprises.

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There are also certain "horizontal" limitations pertaining to all sectors, including the financial sector. Two are worthy of note. One relates to the Aliens Landholding Act which a number of countries have modified, or are in the process of amending, so as to reduce the disincentive to foreign investment in the financial services and other sectors. A second is the "work permit" system relating to the movement of natural persons. In many CARICOM countries, senior managerial and technical personnel of foreign financial institutions need approval for a stay beyond 30 days and, theoretically, permission is only granted if it can be shown that such skills do not exist locally. Nevertheless, these regulations are exercised with a considerable degree of flexibility and discretion.

Now how much regulatory dismantling and liberalisation did CARICOM countries make during the WTO/GATS negotiations relating to the Agreement on Financial Services. Nine (9) CARICOM countries made commitments in the area of financial services in 1994 and, in the 1997 negotiating round, only one country, Jamaica, chose to do so. In 1994, almost every one of the countries committed itself to total liberalisation of the reinsurance sector following the devastating effects of hurricanes in the immediately previous years. The related contracting and decline of major international reinsurance markets and the withdrawal of several important international reinsurers caused a declining availability of reinsurance and sharply rising reinsurance costs. Four of the countries also made a commitment to liberalise in the life and non-life insurance sectors and only one country made an offer in the area of banking. In 1997, Jamaica submitted revised commitments in the area of life and non-life insurance and, for the first time, made a commitment, with respect to banking services and also, one aspect for securities related financial information, i.e., financial data processing and related software by providers of other financial services.

There are at least three factors worthy of note with respect to commitments made so far by the CARICOM region. First, as mentioned above, the offers are only partial in that a number of the countries did not submit a schedule in the area of banking and related services and, to a lesser extent, insurance and related financial services. Second, in almost all respects the commitments constituted a mere reflection of the status quo. This does not necessarily indicate a lack of willingness on the part of these countries to participate in the WTO process of increasing international openness. Rather, It suggests that the Caribbean already possesses a very liberal financial services regime. Moreover, there are advantages to be gained from submitting a schedule of commitments that represents only the status quo, since it subscribes to the WTO objective of greater transparency (Article III). It also sends the correct signals that the country is ready for business and contributes to the process of promoting greater foreign investment and other commercial activity.

Third, Jamaica, in its 1997 submission, exhibited a certain healthy reservation with respect to cross-border supply and consumption abroad modes of supply. Whereas, in 1994 Jamaica indicated no limitations with respect to the application of these two modes of supply of insurance, in 1997 it reversed itself and chose to be unbound with respect to both life and non-life insurance services and, also, services auxiliary to reinsurance (including brokering and agency services). In including banking services in its schedule for the first time in 1997, Jamaica also elected to remain unbound for the cross border and consumption abroad modes of supply with respect to acceptance of deposits and other repayable funds from the public and, also, lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions.

Fourth, the CARICOM strategy in approaching WTO negotiations in the financial sector is probably akin to gradualism rather than a "big-bang" across the broad or indiscriminate type of opening-up. For example, with particular reference to cross-border supply and consumption abroad, Jamaica is wary of the effect that unrestricted electronic commerce may have on employment and income generation in those indigenous companies and foreign branches and subsidiaries located in its territory, in addition to creating problems for the governmental authorities with respect to monetary control. The experience of other countries with the new technology-driven forms of commerce would then be a guide as to whether it would remove such limitations in the future. If the other CARICOM countries choose to make a commitment before the 30 January 1999 date for the ratification of the Fifth Protocol, they may very well reverse their 1994 position and elect this time to be unbound with respect to cross-border supply and consumption abroad modes of supply. In light of the current portfolio investment crisis in emerging securities markets, the Caribbean also probably made the correct decision not to make a WTO offer in this area.

What inference can we draw from the above concerning competitiveness in the financial services area as the Region approaches the 21st Century. There are two modes of supply that are of real relevance here - commercial presence and cross-border supply. With respect to commercial presence, there were hardly any licensing and other non-prudential regulatory barriers to physical entry of foreign financial firms and yet the last two decades there were hardly any newcomers. The greater transparency of the financial services regime that results from participation in the WTO process (even if it merely involves offering the status quo) while positive and informative to would-be foreign investors, may also not result in a rush to enter by firms from either traditional or non-traditional sources since the market is rather small and there are probably more attractive foreign locations where significant opening up is taking place, also. At the same time, while a low absolute level of profits may act as a disincentive to entry, the rate of return could be quite high. Table 7 shows that the average returns for the banking industries of four Caribbean countries (The Bahamas, Belize, Jamaica and Trinidad and Tobago) over 1990-1996 were more than twice that of international markets, owing partly to the intensive competition in the more mature and developed international markets and partly to the high interest rate spreads generally evident in the Caribbean.

Any incremental increases in competition to emerge are likely to be of an intra-regional nature (rather than emanating from extra-regional sources) given recent experiences of cross-border investments by firms from Jamaica and Trinidad and Tobago, in particular. A stimulus to such activity could occur, for example, if differences between national and regional firms in the minimum capital requirement were to be eliminated. However, even here the increase in competition may be limited. There are hidden barriers in the form of regional firms being unable to compete with well-established international brand names of the transnational banks and the high interest and other organisational and inferior location costs that would be involved in trying to coax customers away

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from these banks. Another inhibiting factor are the transaction costs that would be incurred by customers who would be sacrificing goodwill and related service benefits in switching from one bank to another (Bourne, et al, op. cit.)

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TABLE 7: SOME CARICOM/INTERNATIONAL COMPARISONS OF BANKING OPERATIONS

1. Total Cost/Income Ratio

Average for Ten largest International Banks (1997)	67.5%
CARICOM Bank Average (1990-96)*	84%
Range for Ten largest International Banks (1997)	42.7%-93%
Range for CARICOM Countries (1990-96)*	74%-94%

2. Pre-Tax Rate of Return on Assets

Average for Ten Largest International Banks (1997)	0.93%
CARICOM Bank Average (1990-96)*	2%
Range for International Banks (1997)	-0.02%-1.91%
Range for CARICOM Countries (1990-96)	1%-3%

3. Total Cost/Total Assets

CARICOM Average (1990-96)	24%
Range for CARICOM Countries (1990-96)*	8%-19%

Source: C. Bourne et al, 1998 and based on: For International Banks - The Banker, July 1997 and for CARICOM banks - Central bank and own Annual Reports.

*The Bahamas, Belize, Jamaica and Trinidad and Tobago

The bulk of competition is therefore likely to remain internally, rather than externally generated, i.e, among the existing firms. In this regard, there is a relatively high degree of concentration in the financial sector. For example, while there are already relatively few firms in the commercial banking industry, in many countries one-third of them account for about two-thirds of the assets and deposits. A modifying factor in the OECS is that a unit banking model still tends to obtain since, of the 44 locations only five banks are present in more than one territory and only one bank (incorporated outside of the area) operates in each of the eight territories. A high degree of concentration also occurs in the merchant bank industry and, despite its considerably large number of corporate entities, the insurance industry. Foreign firms almost invariably number among the largest financial institutions, the *defacto* industry leaders.

As mentioned earlier, a significant part of any increased competition is likely to stem from intra-regional sources whereby a firm located in one CARICOM country sets up a subsidiary in another CARICOM country. Table 8 on the commercial banking industry and Table 9 on the insurance industry (and its constituent 'life', ' non-life' and 'combined' segments) show that the CARICOM/Caribbean enterprise is beginning to assume a significant presence. There is even emerging new cross-industry competition within the finance sector, involving commercial banks and insurance companies, to add to that between commercial banks and near banks. One-stop banking and universal banking may therefore be on the rise on the new liberal environment Table 10 shows that if national treatment obtained with respect to minimum capital requirement, regional cross border activity might even be greater. Those firms that do not have an intra-regional capability are also likely to take up the competitive challenge. However, all of this may simply amount to an increase in 'static competition', rather than dynamic competition, especially since a certain amount of tacit collusion and cooperation (partly encouraged by the authorities for prudential reasons) tends also to obtain.

Nevertheless, as mentioned above, figures for four major economies, based on three standard measurements, revealed encouraging results in the banking sector. For the total costs/total assets measurement, the 1990-1996 data revealed a downward trend, probably because of the benefit of an increasing scale of operations. For the total cost/total revenues rates since 1990, the rates also declined suggesting increasing efficiency and innovation over time, even though the CARICOM figure tended to be over 0.80 whereas from the ten largest international banks it was less than 70 per cent. With respect to rate of return, CARICOM easily outperformed its international counterparts, even though high interest rate spreads were the main reason (See Table 9).

The future real sector impact of finance sector developmental trends is therefore expected to be not entirely unfavourable, at least in the short run. The responsive capacity of the real sector is likely to be just as important as the supply elasticities and operational stability of the finance sector.

TABLE 8: LOCAL, REGIONAL AND EXTRA-REGIONAL OWNERSHIP STURCTURE OF COMMERCIAL BANKS IN 1997

COUNTRY	NO. OF BANKS	LOCALLY OWNED	CARICOM	FOREIGN OWNED
ANGUILLA	4	2	0	2
ANTIGUA	9	2	1	6
BAHAMAS	11	2	0	9
BARBADOS	7	4	1	4
BELIZE	4	1	0	3
DOMINICA	5	1	0	4
GRENADA	5	1	2	2
GUYANA	7	3	2	2
JAMAICA	8	5	0	3
MONTSERRAT	3	1	0	2
ST. KITTS-NEVIS	6	2	1	3
ST. LUCIA	7	2	1	4
ST. VINCENT & THE GRENADINES	5	1	1	3
SURINAME	6	5	0	1
TRINIDAD & TOBAGO	6	5	0	1

Source: C. Bourne et al, 1998

TABLE 9: OWNERSHIP STRUCTURE OF THE CARICOM INSURANCE INDUSTRY

1995 (or closest)											
Total Number of Insurance Firms			Local			Caribbean			Extra-Regional		
L	NL	COM	L	NL	COM	L	NL	COM	L	NL	COM
29(1996)	48	-	6	4	-	2	4	-	21	40	-
1(1997)	-	6	-	-	3	-	-	3	1	-	-
13(1995)	18	-	9	16	-	1	0	-	3	2	-
11(1995)	41	8	-	16	6	5	15	1	6	10	1
3(1997)	4	-	1	4	-	1	-	-	1	-	-
13(1994)	26	8	13	24	7	1	2	1	2	0	0
70	137	22	29	64	16	10	21	5	34	52	1

Source: C. Bourne et al, 1998

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TABLE 10: EXAMPLES OF MINIMUM CAPITAL REQUIREMENT DISTINCTIONS BETWEEN LOCAL AND FOREIGN COMPANIES OPERATING IN THE CARIBBEAN

COUNTRY	INSURANCE		COMMERCIAL BANKING		
	LOCAL	FOREIGN	LOCAL	FOREIGN	FOREIGN/LOCAL RATES
Belize	n.a.	n.a.	$3M	$50M	17.1
Grenada	Between $250,000-500,000	Between $750,000-1 Million	n.a.	n.a.	n.a.
Guyana	n.a.	n.a.	G$250M	G$2,500M	10.1
Jamaica	n.a.	n.a.	J$80M	J$250M	3:1
Montserrat	$250,000	750,000	n.a.	n.a.	n.a.
Saint Lucia	Between $50,000 and $1 Million	Between 1.5 Million and 2.5 Million	n.a.	n.a.	n.a.

Source: C. Bourne et al, 1998

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(V) Finance Sector Stability and Economic Development

Financial sector stability is essential for sustained economic development. One type of cross-border instability relates to portfolio investment and the rapid movement of such funds out of a host country's stock market when a fall in the exchange rate or a real sector downturn is anticipated, any investor action then makes the prediction self-fulfilling. In certain cases, this flight can be due to a weakness in macro-economic policy and related "fundamentals". In other cases, it may be mainly due to cross-border contagion and the international transmission of crises of confidence and speculative (albeit defensive) maneuverings. The other type of instability relates directly to the banking system (commercial banks and near banks) because the very risky activities that high interest rates necessitate being undertaken by lenders and borrowers finally induce collapse and threaten bank solvency. Of course, the two phenomena can be directly related, as in the case of the crisis that descended on South-East Asia in late 1997, in which a considerable proportion of the cross border funds being recalled represented short-term loans to the commercial banks and which had been used to finance risky and speculative long-term activity (Joseph Norton, 1998). It is estimated that foreign banks lent the Asian economies in crises as much as $100 billion in 1996 but in the second half of 1997 called in more than half of those loans.

The Caribbean is not prone to the first type of crisis since the holding by foreigners of national securities hardly exists, although some of the same characteristics can be exhibited when nationals trigger a flight of capital. The second phenomenon has occurred in the Caribbean on at least two occasions within the last decade-and-a-half. In Trinidad and Tobago the collapse of the real estate market led to the failure of one financial institution in 1983 and certain mortgage institutions, finance houses and other non-banks had to be rescued in 1985 by sustained injections of funds from the Central Bank. In Jamaica, the lack of a sufficiently large number of viable projects that could absorb an apparently inelastic demand for loans, despite the astronomically high rates of interest,

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finally caused speculation-induced default and collapse in 1998 of a number of banks and near banks necessitating a massive programme of restructuring and consolidating by the regulatory authorities. Besides the local commercial banks, merchant banks and finance houses also found themselves in trouble.

Financial institutions in a liberalising environment can sometimes find themselves in a moral hazard situation of lending at high rates of interest (to offset monetary policy induced high deposit rates) to high-risk borrowers, thereby courting insolvency. One manifestation of moral hazard in the Jamaica situation apparently was, according to Bruce Golding, that "some of those delinquent borrowers are themselves connected parties to the bank" (The Gleanor, 13 July 1998). Besides such 'insider lending', another manifestation of moral hazard was that financial institutions took excessively risky positions in the expectation that in a crisis the Government of Jamaica would bail them out (The Gleanor, 16 July 1998). Greater liberalisation therefore requires improved regulation and supervision. The two things are not contradictory. For example, Trinidad and Tobago introduced Deposit Insurance as a result of its mid-1980s financial crisis and Jamaica has now decided to do so as a result of its 1998 crisis. In fact, supervisory authorities are expected to endorse in October 1998 the 25 Basle Core Principles for Effective Banking Supervision in seven broad areas:

1. The preconditions for Effective Banking Supervision
2. The Licensing and Structure of Institutions
3. Prudential Regulations and Requirements
4. Methods of Ongoing Banking Supervision
5. Information Requirements
6. The Formal Powers of Supervisors
7. Cross-Border Banking

Although the Basle Core Principles are necessary as a basis for effective 'outsider' regulation and supervision, they are probably not sufficient. For example, deposit insurance may cause the exercising of even greater riskiness in portfolio selection. This is because "bank owners bear only a portion of the downside risk but stand to gain, through higher profits, a large share of the upside risk" (Martin Brownbridge, 1998). This outsider regulation and supervision should be complemented with a healthy dose of 'insider' regulation and supervision, by bank managers and directors. For example, "actual risk-based capital ratios exceed the 8 per cent level considerably in many industrialised and developing countries, and reach almost 20 per cent in Argentina or Singapore (WTO, 1997, P. 28). That way, banks and other financial institutions in their more stable mode could make a greater contribution to promoting a more stable growth path of the real sector, as against periodic wide fluctuations of a 'stop-go' process.

(VI) *<u>Conclusion</u>*

1. The banking and finance sector has grown considerably within the last two decades in the Caribbean, both absolutely and as a proportion of GDP. Just as important has been both the change in the market share of the various industries within the banking and finance sector and the changing product mix and related quality improvements in the various financial services.

2. The impact of the banking and finance sector on economic development has been influenced, negatively or positively, by the policy of the Ministry of Finance and Central Bank; the underlying business philosophy of the finance institutions themselves; the attitude of available borrowers; and the increasingly overarching nature of the globalisation process and integration into the world economy.

3. The policy authorities in the Caribbean have impacted directly or indirectly on the economic development process by their structural regulation relating to the boundaries between the various finance sectors and industries; their monetary regulation relating to capital adequacy, industry and individual borrowing concentration, and other counters to systemic risk.

4. In the 1980s the dictates of macro-economic policy and balance of payments objectives resulted in credit ceilings and high reserve requirements being imposed on the commercial banks and this could not have had a favourable impact on the rate of economic growth. At the same time, the lack of similar controls on the non-bank sector meant that the latter probably partially filled the credit gap, although the mix of borrowers could not have been exactly the same.

5. In the liberalising 1990s, with the removal of ceilings on credit and/or interest rates, and the loosening of capital controls, a great deal of the structural adjustment burden of maintaining fixed or relatively stable exchange rates has fallen on interest rates. While high interest rates help to attract footloose funds and stem capital flight, such rates must have had an adverse effect on investment. Whether this was compensated for by a more stable economic environment and related growth stimulus is anybody's guess.

6. The financial institutions, themselves, played both a passive and dynamic role in furthering economic development. At one level, they remained quite conservative, even though at one period in Barbados and Trinidad and Tobago, high "reserve requirements are associated with increased bank risk" (M. Williams, 1996, p. 226) and recent experience in Jamaica suggests that very high interests are inevitably associated with rather risky types of

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investments. At another level, the financial institutions exhibited a great deal of dynamism in terms of new products, instruments and other innovations and this would have had a favourable impact on economic development.

7. Of the two major types of financial institutions, offshore financial services and securities related financial services, that do not necessarily have a presence in every CARICOM territory, i.e., obtain in some but not in others, the former is probably poised for a take-off (despite both the growing international competition among countries offering such sites ad the OECD attach against tax havens) while the latter is likely to remain relatively dormant given the current global crises in equity markets. While "many of the OECS countries are becoming increasingly convinced that the development of financial services has a pivotal role to play in the development of these economies" (J. Feracho and W. Samuel, 1997) these countries and others such as The Bahamas and Barbados have to ensure that unscrupulous money launderers and other related episodes do not tarnish their reputation and so adversely affect investor confidence. In addition, some thought should perhaps be given to beginning an integration process of gradually linking offshore and onshore activities, even though this would considerably increase the regulatory and administrative burden. For example, while in a number of countries offshore banks can accept foreign currency fixed deposits from residents, other countries have gone even further. In Singapore, each offshore bank can extend to residents Singapore dollar loans but not exceeding S$100 million in aggregate. The offshore banks are also allowed to borrow freely from the domestic inter-bank market. In addition, offshore banks can accept from non-residents fixed deposits of S$250,000 in Singapore dollars (WTO, 1996). This could possibly have significant developmental implications.

8. Just as the financial services sector has an obligation to seek out socially worthwhile projects for financing, so business borrowers ought to have the duty of coming up with viable activities having a significant developmental impact. However, entrepreneurship is probably in short supply. Moreover, exceedingly high interest rates would tend to attract either ventures of a speculative nature or those activities in which it is easy to pass the burden on to consumers. Export activities that face stiff international competition would therefore not be favoured owing to the effect of very high interest rates on costs of production. A high rate of re-investment would only partly alleviate this situation. Effective access to offshore financing would be required.

9. The financial sector of the Caribbean region probably suffers from systemic market failures and this would tend to have an adverse effect on development in the real sector. The loans structure is probably too consumption oriented (with a skewed distribution, moreover, that vitiates the human development factor) and the investment portfolio biased towards low priority activities, with both having a high import leakage. Financial gaps abound, the most obvious being the dearth of lending to micro-enterprises by the commercial banking system and the inability of Development Banks (themselves a failure in certain countries) to take up the slack. For financing very large investments, the individual banks in the Caribbean seldom ever form consortia among themselves to institutionally diversify the risks. When we take into account the stagnation in the securities markets in the Caribbean Region and fast dwindling official development assistance, increasing reliance will inevitably be placed on foreign direct investment, itself an unpredictable (though long-term) variable with important real sector ownership implications.

10. The international volatility of portfolio investment, as attested by the current global financial crisis, is not likely to have a direct impact on the regional developmental process (except as a result of declining world demand for commodities and tourism services) in the short- or medium-term, given the very underdeveloped state of the Caribbean securities markets. However, interest rate spreads are likely to become even greater than they have been in recent years as countries struggle to combat the contagion effect and to encourage funds to remain at home. Globalisation therefore has its downside in the way the process articulates itself and the related easy international transmission of crises.

11. What lessons can the Caribbean banking and finance sector hope to learn from the South East Asian) and Russian and Brazilian) financial and, ultimately, developmental crises. There are said to be at least six financial factors (with related lessons) accounting for the shift from an Asian Miracle to an Asian Meltdown:

(a) Unrestrained borrowing from the international inter-bank market of continuously rolled-over short-term loans could constitute a liquidity problem if there is a sudden recall, since the funds would have been committed to long-term borrowers. Such a sudden and massive withdrawal can create problems for the foreign exchange reserves situation even in export oriented economies. This is especially the case in situations where the exchange rate is fixed to the USA dollar whereas some international loans are in another currency which is changing value, in relation to the USA dollar. (Unfortunately, the international rescue system is not designed to penalise those international lenders who threw funds at the Asian banks and the adjustment burden tends to fall entirely on the borrowing country).

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(b) Moral hazard and the incidence of risky lending to investors may tend to rise not only because borrowers have to be found for the international inter-bank loans but, also, because the banks feel that the state, eager to prevent contraction and for the country to retain its global competitive position, would ultimately bail them out.

(c) "Crony capitalism" (favouring family, friends and political acquaintances) is one of the reasons for the increase in moral hazard. In addition, the state-private sector alliance, whose role was so instrumental in producing over two decades of miraculous growth might have taken the concept of "picking winners" to such an extreme as to verge on the speculative. The 'pyramid' nature of this situation took some time to be revealed.

(d) As with the international inter-bank market, internationalisation of the securities markets to permit not only intra-regional transactions but, also, extra-regional cross-border movements can at times have a disruptive developmental impact.

(e) At the regulatory level, prudential measures are more necessary the greater the degree of liberalisation. Accordingly, minimum capital requirements ought certainly to be risk based and concentration ratios with respect to loans to particular industries or individuals ought to be carefully monitored.

(f) A corrective policy based on high interest rates, is not always the solution, especially when the excessive borrowing has been by the private sector, rather than the State.

12. Finally, there needs to be a change not only in domestic policy but, also, international policy for banking and finance to have a greater impact on economic development. Three aspects are particularly relevant in order to arrive at a level playing field. First, monetary adjustment policy needs to be more conducive to maintaining growth and retaining a country's competitive edge. It is interesting that as a counter to the current global financial crisis the course deemed appropriate for Japan and the USA is a lowering of interest rates (which were already very low) and expansion whereas that imposed on the developing countries is one of massive raising of interest rates (to nearly 50 per cent in the case of Brazil) and contraction, of between 15-19% GDP in Asia during the first half of 1998, with all its dire social consequences. The failure to resolve this contradiction between growth and stabilisation has intensified the economic slide in developing (particularly Indonesia) and transitional economies and caused a rift between the World Bank and the IMF. (New York Times, 2 October 1998).

Second, a distinction needs to be made between policy prescription for an exchange crisis and that for a banking crisis. "The cure for a foreign exchange crisis is tighter monetary policy and the cure for a banking crisis is looser monetary policy. So where the two co-exist there is a natural dilemma. Talk of reforming the architecture of the international financial system must begin by examining how policymakers wish to cope with the dichotomy" (Financial Times, 2 October 1998).

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Third, there is need for a defence relating to speculative attacks against a country's currency. While the need is greatest for those countries that are hosts to either large foreign loans or portfolio investment, it is also relevant to all others who would be concerned about a flight of domestic capital. Fixed exchange rates are vulnerable to speculative attacks but floating rates less so and a currency board anchor (which however lacks expansionary/contractionary monetary flexibility) the most secure of all. Malaysia has resorted to capital controls. Many developing countries are of the opinion that a 'Tobin Tax' on capital transactions would help to dampen the volatility of cross-border movements. President Cardoso of Brazil has called for a 0.5% tax.

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